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## **How Germany Became the China of Europe**

**By Michael Schuman / Stuttgart**

There is no particularly special technology needed to make a chainsaw. It's really just plastic and metal parts screwed together with old-fashioned nuts and bolts. The Chinese already make chainsaws. But that hasn't stopped German power-tool manufacturer Stihl from selling its made-in-Germany chainsaws around the world, even though its top-end models are among the priciest on the market. In fact, 86% of the products Stihl makes in its high-cost German factories are exported. How Stihl manages that says a lot about the impact a revived German economy is having on Europe and the world — both good and bad.

The family-owned firm, based near Stuttgart in Germany's south, could shift more production to its lower-wage factories in China and Brazil, but management is committed to manufacturing many of its most advanced products at home. In contrast to the American habit of outsourcing as much as possible, about half the parts in a German-made chainsaw — from the chain to the crankshaft — are produced in Stihl factories, and many of them are made in Germany. And instead of laying off staff during the Great Recession, as so many U.S. firms did, Stihl locked in highly trained talent by offering full-time workers an employment guarantee until 2015. Stihl even added specialists to its product-development team during the downturn. The result is high-quality products that command price tags big enough — professional Stihl chainsaws cost as much as \$2,300 in Germany — to make manufacturing profitable even with the nation's high wages. U.S. companies "don't try hard enough to keep production inside the country," says Stihl chairman Bertram Kandziora.

Stihl defines how Germany resurrected its economy — and how the U.S. might too. The small, often family-owned enterprises that make up the backbone of German manufacturing have historically specialized in the unsexy side of the industrial spectrum: not smart phones or iPads but machinery and other heavy equipment, metal bashing infused with sound technology and disciplined engineering. But in recent years, German firms, aided by farsighted government reforms, have turned that into an art form, forging the most competitive industrial sector of any advanced economy. The proof is a boom in exports, which jumped 18.5% in 2010, that is the envy of the developed world.

That surge has carried Germany out of the Great Recession more quickly than most major industrialized countries. GDP rose 3.6% in 2010, compared with 2.9% in the U.S. While joblessness in the U.S. and much of Europe has spiked to levels not seen in decades, unemployment in Germany has declined during the crisis, to an estimated 6.9% in 2010 from 8.6% in 2007, according to the Organisation for Economic Co-operation and Development (OECD). "Germany is in a very competitive position today, more than ever," proclaims Stéphane Garelli, director of the World Competitiveness Center at the Swiss business school IMD.

Germany's revival has reversed its role in Europe. Less than a decade ago, Germany was a bumbling behemoth beset by chronic unemployment and pathetic growth. As its more aggressive neighbors such as Spain, Britain and Ireland rode the craze in global

finance to stellar performances, they looked at Germany as their stodgy old uncle, unable to change outdated, socialist habits and adapt to a new world. But the financial crisis proved just the opposite. While Spain, Ireland and other former euro-zone highflyers tumble into debt crises, victims of excessive exuberance and risky policies, a steady but reformed Germany has emerged as Europe's dominant economic power. According to the OECD, Germany accounted for 60% of the GDP growth of the euro zone in 2010, up from only 10% in the early 2000s. "We changed from the sick man of Europe to the engine," says Steffen Kampeter, parliamentary state secretary at Germany's Ministry of Finance in Berlin.

Germany's engine, however, has spewed toxic fumes. As manufacturers rev exports, the rest of Europe has been unable to compete. Some 80% of Germany's trade surplus is with the rest of the European Union. The more German industry excels, the more other Europeans feel that Germany's success comes at their expense, cracking open schisms within the euro zone just when the region can least afford them. "There is frustration with Germany," says André Sapir, a senior fellow at Bruegel, a Brussels-based think tank. "Germany is moving ahead, but what are they doing for the rest of Europe?"

## **Europe's China**

In many respects, Germany's role in the world economy is similar to China's. Both are manufacturing monsters that are bringing instability as well as benefits to the world. Because of its export machine, Germany, like China, runs up a humongous current-account surplus, while its less competitive neighbors, like Spain, have fallen into deep deficits.

These differences are at the heart of Europe's debt crisis. Many in the zone blame Germany's export-dependent economy for the region's economic woes, in the same way that Washington accuses China of hampering the U.S. recovery. Unless the economies of Europe are brought into better balance, some economists fear, the region could get stuck in a low-growth pattern that could make the debt crisis harder to resolve, threatening the future of the entire monetary union. Mimicking the argument Washington makes about China, Germany's European partners believe Berlin has to alter its model to better support regional growth. The European Commission, the E.U.'s governing body, has called on surplus nations like Germany to stimulate consumer spending at home in order to help support the E.U. economy as a whole. French Finance Minister Christine Lagarde has complained that Germany must show "a sense of common destiny" and reform its economy for the good of Europe.

Berlin, however, believes German exports are good not just for Germany but for all of Europe. Much like China in Asia, Germany sits at the center of a network of regional suppliers that feed its export industries with parts and other resources. The more German factories export, the more they suck in from Germany's neighbors, sparking growth well beyond its borders. Kampeter points out that German imports from the rest of the euro zone are expanding more quickly than Germany's exports to the region — 16.7% vs. 12.7% in 2010. "A growing Germany is better for the E.U. and the world economy than a Germany that is a shrinking economic power," he says. In German eyes, the answer to Europe's woes isn't a Germany that exports less but reform in the weaker economies to make them healthier and more competitive.

## **The German Model**

It's a strong point. While the Spanish, Irish and other Europeans were gorging on debt, building too many houses and giving themselves fat pay raises, Germans were busy fixing their economy. German companies poured money into R&D and cut expenses. Loosening up the tightly regulated labor market to make it easier for firms to hire and fire helped. Union cooperation meant Germany was the only major European economy that reduced labor costs for several years after 2005. Germany churns out specialized products of such superior quality, from BMW sports cars to Kärcher cleaning equipment, that customers will pay extra for the MADE IN GERMANY label. That has kept the country in front of emerging economies like China's and helped it benefit from their rapid growth. German exports to China surged 45% in the first 10 months of 2010. In fact, Germany is the only major industrialized country other than Japan in which exports are playing a significantly larger role in the economy — 41% of GDP in 2009, from 33% in 2000. German industry may provide an answer to one of the thorniest economic issues facing the developed world: how to maintain manufacturing competitiveness against low-cost emerging economies. Germany "is a road map for the U.S. and other countries," says Bernd Venohr, a Munich-based business consultant.

German executives and policymakers also found inventive ways to ensure that factories kept their edge during the Great Recession. And the nation prevented the sort of large-scale layoffs the U.S. endured during the recession with a short-term work program in which the government subsidized firms to keep workers. At the program's peak, in 2009, more than 1.4 million workers were involved. At BASF's chemicals complex in Ludwigshafen, engineers worked furiously to keep the multibillion-dollar machinery running smoothly as production dwindled. At one of the facilities, demand for its ethylene and other chemicals sank from 100% of capacity to a mere 14% in just 100 days in late 2008. Unable to shut down superhot machinery in winter — the pipes could have frozen, causing costly damage — the plant's engineers kept the facility operating through a complicated recycling scheme. Instead of laying off cherished staff, management deployed idled workers to new assignments. Bernhard Nick, a BASF president, believes the measures taken during the downturn kept the company primed to capitalize on the recovery. "It wasn't just a family feeling or being nice to each other," he says. "Even the normal shift workers have such a high skill level, it is not so easy to lay them off. You lose a lot of knowledge, which would give you big problems starting up again."

## **Crisis Mismanagement**

The successes are prodding the rest of Europe to become more German by copying Berlin's reforms. French President Nicolas Sarkozy stared down protesters late last year and raised the retirement age by two years — a step Germany took in 2007. In June, Spain's Prime Minister, José Luis Rodríguez Zapatero, pushed through the parliament a labor-reform bill, aiming, like Germany, to reduce the nation's perpetually high unemployment. But catching Germany won't be easy. Since Germany and its neighbors all use the euro, the zone's weaker economies can't employ the simplest tool to regain competitiveness — depreciating one's currency, which is the U.S.'s preferred way of reducing its trade deficit with China — and instead must suppress wages and costs.

The German attitude toward the euro zone — that the weak must become strong — has filtered into the country's response to the European debt crisis. Berlin, which holds virtual veto power over E.U. decisions, has pushed prostrate euro-zone partners into painful reform programs in an attempt to rebuild investor confidence. In return, Germany has backed E.U. — International Monetary Fund bailouts from a \$1 trillion fund created last May. But the budget cuts and other austerity measures that go along with the bailouts have only further inflamed the rest of Europe against Germany. Germans "look at Southern Europe, and they see us as a burden," says José Ignacio Torreblanca, head of the Madrid office of the European Council on Foreign Relations. "They think it is better to solve their own problems and the system will take care of itself."

Many economists believe that solving the debt crisis will require not just emergency cash for debt-ridden governments but also a tighter economic union. Yet German Chancellor Angela Merkel has consistently resisted or rejected proposals to address the euro zone's ills that entail greater sacrifices on Germany's part, like a recent call for a Eurobond jointly backed by the region's governments. Granted, Merkel has been hamstrung by voters who are in no mood to see their taxes diverted to profligate neighbors. But some in the region believe the Chancellor is putting her selfish needs over the good of Europe as a whole. Jean-Claude Juncker, the Prime Minister of Luxembourg, recently accused Germany of being "un-European."

### **Rebalancing Act**

Such criticism stings in Berlin. "We see the euro as a peace- and freedom-keeping mission, not only an economic instrument," says Kampeter. "We'll do everything to stabilize this instrument." But Berlin has to do more. The answer to the world's Germany problem is similar to that of its China problem: both countries have to rebalance, to find new sources of domestic growth so they don't distort the global economy.

In Germany's case, that means helping Luka Rajkovic. The 49-year-old has spent his 25-year career on the assembly line of a Siemens power-equipment factory in Berlin. Fully aware that his job could be moved to lower-wage China, Rajkovic and his colleagues have accepted smaller pay raises in return for job security. Late last year, Siemens extended an employment guarantee to 2013. But the bargain leaves Rajkovic searching for bargains. With two children to care for, he delays costly purchases and hunts for sales. "What's the point of earning a little more and losing your job in two years' time?" he says.

All of middle-class Germany has made that choice, and as a result, it isn't benefiting as much as it should from the country's export boom. Markus Grabka, a researcher at the German Institute for Economic Research in Berlin, estimates that the disposable income of the German middle class hasn't increased at all in the past decade. About a fifth of the workforce, he says, is stuck in insecure and poorly paid jobs, often earning a dismal \$550 a month. Ironically, the very factors that are fueling the German export machine — lower labor costs created by greater flexibility — are also pressuring the welfare of the middle class in the same way it has come under strain in the U.S. The solution may be to liberalize tightly regulated domestically oriented sectors — especially services such as education and retail — that are much less productive than manufacturing. Freeing

those industries would create more jobs with better wages and boost the spending power of the German public. It would also help Germany offset its dependence on exports. "You've got the goose that lays the golden egg — the export sector — but that isn't enough to get the entire economy doing better," says Bart van Ark, chief economist at the Conference Board in New York City.

There is a clear awareness of that fact in Berlin. "We have learned that reform is not only a 10-year program but an everlasting challenge," says Kampeter. A more balanced Germany (much like a more balanced China) would minimize the negatives the country's economy is causing for the world and maximize the positives — the U.S., for example, could sell more of its products to German companies and consumers. But for Germany's new economic miracle to be truly secure, the reformist spirit needs to reach outside its borders. In an integrated Europe, Germany can thrive only with its neighbors, not in spite of them, and that requires that Berlin accept reform of the entire euro zone and Germany's role within it. A strong Germany has an opportunity to guide Europe out of crisis, if its leaders are willing to grasp it. "They can promote a future good for everybody," says Torreblanca. "But they don't want to lead." If that changes, Germany will benefit. So will Europe — and the world.

— *With reporting by Claudia Himmelreich / Berlin*